CION INVESTMENTS

Exiting the Wasteland and Entering the New Normal

2020 entered the history books before it entered Q2. Australian bushfires, a crisis in Iran, an impeachment trial, the UK's formal withdrawal from the EU... and that was just January. Soon after, Covid and the world's response dominated headlines.

Notably, the biggest financial surprise of 2020 was investment performance. The power of the Fed was on full display as equity and bond markets soared. Despite nine months of lockdowns, GDP cliff diving, and global social unrest, financial markets had a stellar year.

What can we expect in 2021? Covid has catalyzed existing cultural trends and will continue to redefine what 'normal' is. Those trends may have a greater impact than the virus itself. This piece reviews three trends shaping financial markets in 2021 and beyond. We discuss these trends in more detail below.

2020 Economic Summary and Market Performance

Economic Performance

After Q3's 30+% increase, GDP growth slowed to a 10% rate in Q4, leaving the economy still smaller than it was one year ago. If US GDP grows at its average rate, it will take 18 months to regain the previous peak, a recovery timeline consistent across developed nations. (China, however, has already regained GDP lost by the virus.)

US employment continues to recover, albeit at a slowing rate. Virus-related job losses totaled 22 million and we've recovered 12 million of those so far. The unemployment rate continues to tick down - partly because fewer Americans are seeking work – dropping from 6.9% in October to 6.7% in November.

Monetary Policy Overview

Throughout 2020, the Federal Reserve flooded financial markets with liquidity, supporting equity and credit asset prices, but delinking those asset prices from underlying fundamentals. The Fed's balance sheet, now over $7.3 trillion, has ballooned to levels unimaginable one year ago.

In 2020, the Fed committed to let inflation run hot (i.e., over two percent) and maintain a loose monetary stance indefinitely. Expect rates to remain near zero for years regardless of what happens with inflation[1]. The Fed's near zero rates are comparatively high for sovereign debt, as negative yielding debt worldwide reached $18 trillion in December.

US and Global Equity Market Summary

2020 was a stark reminder that the stock market is not the economy. The S&P 500 and DJIA ended the year at their all-time highs. Tech firms zoomed. The IPO market boomed. SPACs entered the mainstream. The Wall Street Journal dubbed it "The Everything Rally."

The S&P 500 had a wild ride, falling nearly 34% from mid-February to its March 23rd lows, then climbing nearly 70% (!) to end the year at a record high. The 454 IPOs on US exchanges raised over $167 billion, a record amount, exceeding by $60 billion the amount raised during the 1999 dot com boom.

Credit Markets

Investment Grade[2], boosted by plummeting rates, returned 9.9% for the year. High Yield's[3] strong Q4 boosted its full-year return to 7.1% as the Leveraged Loan[4] market returned 3.1% in 2020. Yields, now at record lows, continue to asymptote toward zero, but robust demand was able to absorb high levels of issuance.

Although shutdown-related defaults have ticked up, the expected wave of credit defaults never occurred. Central banks flooded the market with liquidity, PE sponsors supported their portfolio companies, and lenders realized the wisdom in playing nice with borrowers.

The Market Trends Shaping 2021

S&P 500 companies currently have the same profits as in 2018-2019, but now with a 35% higher valuation. Most analysts think it can go higher. We believe that the Covid cycle will drive markets in 2021, cities will struggle as the WFH-lifestyle pushes itself into the "New" Normal, and investors will be more receptive to using alternative investment strategies in their search for yield.

Exiting the Wasteland

The Covid Cycle – Phase 1

'Where are we in the credit cycle?' was the most asked question for the last four years. The Covid cycle has now superseded the credit cycle.

Phase 1 was chaos. That period in early 2020 where it felt like the world was being torn apart. The virus was a novel threat to economic and social stability and had to be attacked with new policy tools in real time. Monetary and fiscal policy contributed some economic stability, blunting some of the worst impact. Asset managers selectively deployed capital in Phase 1.

Phase 2

We are now near the tail end of Phase 2, dubbed 'The Wasteland', a more stable period allowing long term assessment of economic damage and recovery. Defaults will continue to tick-up and asset managers will find more opportunities to deploy capital. However, asset managers will refrain from full deployment until an economic recovery begins to take hold.

Phase 3

If we aren't there yet, then we expect to enter Phase 3 by mid to late 2021, as most people return to work, and virus fears abate. In this phase, baseline expectations become stable, making long-term planning possible. Phase 3 will be a "New Normal" and companies who survive will now have less competition.

Exiting the Wasteland

The State of the City

When you arrive in Manhattan, you'll find an empty city. Long-closed restaurants have covered their windows with plywood, which in turn has been covered with graffiti. Midtown streets, formerly thronged with tourists and office workers, are now empty. The feeling is unsettling, as if the city had been hastily abandoned in advance of an invading army. New York City isn't alone - big cities are struggling.

Florida and Texas, much to the delight of the locals, are being inundated with new residents from California and New York. What happens to the cities left behind?

How a Death Spiral Starts

Given NY's top-heavy tax base – the top 5% pay more than 60% of NYC's income tax, and more than 70% of NY state's income tax – it won't take many residents leaving to start a death spiral.

The death spiral kicks in when enough of the tax base leaves to force higher tax rates on everyone remaining. But the higher rates don't bring new benefits. Instead, services are reduced, crime increases, infrastructure decays. More people move out. Taxes increase again… and so on.

Covid has put this spiral into high gear. NYC is hurting. Office REITs have been pummeled, with NYC corporate lease rates expected to decline by up to 20% in the next two years. By the end of 2021, many city businesses will be gone for good. Communities and cultural networks that made city living viable will permanently relocate. Defining attributes of a city will be reassessed.

What does NYC offer when it no longer has public spaces? How can the tradeoffs of city living be calculated when costs don't provide any benefits - when the restaurants, Broadway shows, concerts, and the sporting events that compensated for the high taxes and cramped spaces, no longer exist?

The Future of Remote Employment

One little discussed consequence of WFH is increased competition. US workers are no longer competing locally. They now must compete with any skilled worker with an internet connection. Companies reluctant to pay New York-based prices for New Mexico-based workers, will happily pay New Orleans prices for New Delhi workers.

Although WFH has, so far, benefitted knowledge workers, who have mostly kept their jobs and high wages; soon those same workers will be fighting in the global employment Thunderdome, a beautiful green flash at sunset followed a by long, bitterly cold night. WFH is nature's way of teaching knowledge workers about the factor price equalization theorem.

Alts Become Mainstream

The Most Expensive Pizza in History

In May of 2010, a bitcoin pioneer placed the most expensive pizza order in history. Florida man, Laszlo Hanyecz, offered: *"I'll pay 10,000 bitcoins for a couple of pizzas.. like maybe 2 large ones so I have some left over for the next day."* The order was filled for 10,000 bitcoin, now worth over $380 million dollars, or $23 million per slice. It was a unique proof of concept at the time, showing that the new currency could be exchanged for real goods.

Bitcoin is now mainstream. Fidelity has launched a Bitcoin mutual fund. Billionaire investors like Paul Tudor Jones are buying it. Even normally staid insurance companies are adding a crypto sleeve. Bitcoin isn't the only niche product with increasing investor interest, and it's no surprise why.

Why Investors are Alt About That Life

The Fed has made it hard to find yield. Institutional investor's target rates that haven't declined nearly as fast as yields. In 2000, a 10-year Treasury yielded 6%; by 2010 that declined to 3%; now the 10-year yields less than one percent, a negative interest rate in real terms.

To get yield, those that have stayed in traditional investments have either: gone further out on the yield curve – moving from a 1-mo treasury to a 30 year gets a mere 1.50% extra yield; taken on riskier investments – the lowest rated Investment Grade bonds make up 36% of the total corporate debt market; or used more leverage – 43% of retail investors used leverage in 2020.

Others are exploring alternative investments. Investor interest in hedge funds, PE funds, and private debt funds is robust. Additionally, these asset classes are now available to more investors than ever, thanks to the SEC's updated definition of an 'accredited investor' in 2020. In other words, alts are now mainstream.

As rates remain low, interest in alternatives will increase, driven by the need for yield and a richly priced equity market. In 2021, prudent investors will expand their options beyond the 60-40. Sleeves allocated to alts will expand to take advantage of the illiquidity premiums and lower volatility these instruments offer.

Parting Remarks

Predictions are, of course, not desires. We would all benefit if herd immunity and vaccinations happen sooner, if working remotely didn't negatively impact big cities, and if the best investment option was a simple 60-40. However, an unblinking assessment of the most probable scenario allows us to best prepare for the future, however harsh that future is.

No one expected the events of 2020, and 2021 may throw out greater curveballs yet. Preparing your relationships, health, and wealth for the worst ensures you'll thrive regardless of the environment.

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[1] There is precedent for long periods of low rates. In the 1940s, to finance the war, the Fed pegged short-term rates at 0.38% and kept it exactly at that rate for seven straight years, a period on the chart as flat and long as a snooker table. It took nearly 15 years for short term Treasury yields to increase above 2%.
[2] As represented by the Barclays Capital US Investment Grade Bond Index.
[3] As represented by the Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD
[4] As represented by S&P/LSTA Leveraged Loan Total Return Index